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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 151

UNITED STATES OF AMERICA,
Petitioner,

vs.

JOLIET & CHICAGO RAILROAD COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT.

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CITATIONS.

MISCELLANEOUS.

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BRIEF FOR RESPONDENT.

Preliminary Statement.

In 1864 this respondent parted irrevocably with all of its property and with all right to or control over any income that it might produce. The right to the income was effectively and indefeasibly vested in its stockholders by the indenture of January 1, 1864. Thus, the case is easily distinguishable from the constructive receipt cases, and the Regulations[1] implementing their rationale, relied on by petitioner. This case falls into a different category, as indicated by the court in *Gold & Stock Telegraph Co.* v. *Commissioner,* 83 F. (2) 465, when it said, at page 467:

"Had all future rentals been assigned by the lessor

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1. Art. 70, Treasury Regulations 74, promulgated under Revenue Act of 1928; Art. 70, Treasury Regulations 77, promulgated under the Revenue Act of 1932; Art. 22(a)-20, Treasury Regulations 86, promulgated under the Revenue Act of 1934.

to the stockholders, the case would have been different from that before us."

The limitations of the constructive receipt cases defeat petitioner's reliance upon them. There is no other basis for liability, and no case has gone as far the petitioner's contention here. When the fictionland of the constructive receipt cases is abandoned, the inquiry moves in to the clearer atmosphere where "common understanding and experience are the touchstones for the interpretation of the revenue laws" (*Helvering* v. *Horst*, 311 U. S. 112, 118).

Here we find ready support for the decision below. He who has no ownership of, or control over, property or the income it produces, is not subject to tax upon such income. True, the existence of the power to control income is deemed equivalent to ownership (*Helvering* v. *Horst*, 311 U. S. 112, 118; *Reinecke* v. *Smith*, 289 U. S. 172, 177; *Corliss* v. *Bowers*, 281 U. S. 376, 378), and exercise of that power may constitute taxable realization of income (*Helvering* v. *Horst*, 311 U. S. 112, 118). But a controlling factor in these cases is the relation between the donor or assignor and the property producing the income. In the absence of ownership of or control over the property or the income, no tax is due from the donor or assignor (*Blair* v. *Commissioner*, 300 U. S. 5, 12, 13; *Helvering* v. *Horst*, 311 U. S. 112, 119). The court below therefore properly concluded (118 F. (2d) 174, 177; R. 52, 53):

> "The indenture agreement of 1864 did two things—(1) it put the ownership of all the corporate assets, together with any income therefrom, irrevocably out of the hands of the plaintiff and into the hands of the grantee, and (2) it created a contractual obligation in favor of the shareholders, definite in amount, and in their right of enforcement. By this agreement, the shareholders succeeded to all the right which plaintiff might otherwise have had to this income, and, therefore, it is their income and not that of the plaintiff, either actually or constructively."

STATEMENT.

Petitioner's statement is somewhat inadequate. It should be pointed out that the indenture of January 1, 1864 contained no provision under which the tenure of the grantee therein could be terminated for failure to perform any of the covenants thereof, nor did it contain any provision for the payment of rent to the grantor. The court below so found (118 F. (2) 174, 175; R. 49).

The indenture also provided with respect to the payment of the "dividends" that funds to pay the same should be deposited with the United States Trust Company of New York monthly, "each and all of which deposits so made shall be placed by the said United States Trust Company to the credit of the stockholders of the party of the first part, as a fund for the purpose of paying to said stockholders, or to their legal representatives or assigns, the dividends hereinbefore provided to be paid quarterly to them" (R. 12).

Certain matters of terminology need clarification. The indenture of January 1, 1864 is called a lease but it is not a lease. "What it was styled by the parties does not determine its character or their legal relation" (*Union Pacific Ry. Co.* v. *Chicago, Rock Island & Pacific Railway Company,* 163 U. S. 564, 582).

The indenture provides for the payment of "dividends" but these payments are not dividends (*Harwood* v. *Eaton,* 68 F. (2) 12, 14). They do not represent earnings of respondent or of the property it conveyed in 1864. They are payments made in fulfilment of a promise made directly to respondent's stockholder's and enforceable by them.

The promisees under the indenture are referred to as stockholders. But their shares represent none of the economic attributes of corporate shares. The value of the

shares, on the contrary, derives solely from the promise made directly to the holders of the shares by respondent's grantee and its successors.

Petitioner frequently uses the terms "lessor" and "lessee". Respondent is not a lessor and has no lessee. The issues in this case are controlled by legal rights and powers, not terminology.

The issues raised by petitioner do not controvert the principles urged by respondent so much as they seek to challenge their application. We shall first outline briefly the principles upon which we rely, and then discuss the fallacies in petitioner's argument.

SUMMARY OF ARGUMENT.

The indenture of January 1, 1864, being a lease in perpetuity without defeasance clause, effectively conveyed fee simple title to the grantee therein named, its successors and assigns. That indenture also effectively divested this respondent of all interest in or control over the payments undertaken to be made to the holders of this respondent's shares. It effectively vested the right to the payments in such holders as third party beneficiaries. Thus, the generating source of the right to the payments is the promise contained in the indenture of January 1, 1864, not the fact that the promisees are identified as the holders of respondent's shares. That identification is purely a matter of convenience. The machinery provided in the lease for deposits with a Trustee for the account of the holders of the shares, their legal representatives and assigns, indicates that the corporate existence of respondent is unnecessary for the preservation of the rights of the third party beneficiaries.

The constructive receipt cases have based liability for tax upon the circumstance that in those cases there was no absolute assignment of income to the stockholders, and that title and the consequent sanction of forfeiture continued in the lessor corporation, whose stockholders received the income from the property it still owned. The limitations in these cases themselves prevent their applicability to the case at bar. Under general principles of tax law, liability for tax cannot attach to an assignor of income unless the assignor still has some interest in or control over the property producing the income or the income itself. Neither statute nor regulation can by fiat declare that that which is in fact the income of A shall be taxed as the income of B. The decision of the court below was correct and should be affirmed.

ARGUMENT.

I.

The Indenture of January 1, 1864 Effectively Conveyed a Fee Simple Title to the Grantee Therein Named, Its Successors and Assigns.

A lease in perpetuity, containing no defeasance clause, conveys a fee simple title. This proposition, which was concurred in by the court below, is not challenged by petitioner. It is sustained by ample authority: *Jamaica Pond Aqueduct Corporation* v. *Chandler*, 91 Mass. 159, 167-168; *DePeyster* v. *Michael*, 6 N. Y. 467, 497; *State* v. *Mississippi River Bridge Company*, 134 Mo. 321, 336; 35 S. W. 592, 596; *Walsingham's Case*, 2 Plowden, 547, 557; *Van Rennsselaer* v. *Hayes*, 19 N. Y. 68, 76; *Wells* v. *Savannah*, 87 Ga. 397, 400, 13 S. E. 442, 443; *Penick* v. *Atkinson*, 139 Ga. 649, 652, 77 S. E. 1055, 1057; *Atkinson* v. *Orr*, 83 Ga. 34, 9 S. E. 787; *Hudson Tunnel Company* v. *Attorney General*, 27 N. J. Eq. 573, 578; *Ocean Front Improvement Co.* v. *Ocean City Gardens Co.*, 89 N. J. Eq. 18, 25, 103 Atl. 419, 421; *Kavanaugh* v. *Cohoes Power Light Corporation*, 187 N. Y. Supp. 216, 231; *Wallace* v. *Harmstead*, 44 Pa. 492, 495; *Hill* v. *Atlantic Railroad*, 143 N. C. 539, 567, 55 S. E. 854, 864; *Huck, et al.* v. *Chicago & Alton Railroad Co.*, 86 Ill. 352, 354; *Wiggins Ferry Co.* v. *O. & M. Ry. Co.*, 94 Ill. 83, 93; *Chicago, Burlington & Quincy Railroad Co.* v. *Boyd*, 118 Ill. 73, 75, 7 N. E. 487, 488.

This effect of the indenture of January 1, 1864 is no vagary of Illinois law, but is a rule of property applied universally, in Illinois and elsewhere. The decisions of the state courts in regard to property rights and the effect of conveyances executed within the state relating to property situated therein, are controlling. (*Tyler* v. *U. S.*, 281 U. S.

497, 501; *Frueler* v. *Helvering,* 291 U. S. 35, 45; *Blair* v. *Commissioner,* 300 U. S. 5, 10.)

The significance of this factor in the case at bar cannot be overestimated. It cuts the last thread of ownership; it means that the respondent is without that sanction of forfeiture, which is a right that a lessor may exert to enforce compliance with a lease. It means that there is no underlying title in respondent to the property producing the income that goes to its stockholders. It means that there is no remedy for any breach of the indenture of January 1, 1864, except a suit to compel the payments therein stipulated to be made to the third-party beneficiaries of that indenture.

II.

The Indenture of January 1, 1864 Vested All Right to Payments of Dividends in Respondent's Stockholders, and Divested Plaintiff of Any Right to, or Control Over, Such Payments.

The indenture provides that:

> "The said party of the second part [the grantee] will guarantee and pay unto the holders of the shares of all the capital stock of the [respondent] * * * an annual dividend of seven percentum, upon the par value of said shares of capital stock * * *." (R. 12.)

Respondent is as devoid of any rights to or interest in the dividends which the grantee under said indenture guaranteed to pay to plaintiff's stockholders as it is devoid of any right to or interest in the property or the line of railroad which it demised under said indenture.

This point is so ably and completely discussed by the Supreme Court of Wisconsin in the case of *Northwestern Telegraph Co.* v. *Wisconsin Tax Commission,* 212 Wis. 219, 248 N. W. 164, that we quote from it at some length. In that case the lease involved was for a term of ninety-nine

years, and the lessor had the right to forfeit the lease in the event of breach by the lessee. It was, of course, a true lease, and title remained in the lessor. The lessee's obligation, however, was to pay dividends directly to the stockholders of the lessor under provisions substantially like those in the indenture involved in the case at bar. The court said (212 Wis. 225, 248 N. W. 166):

> "The control over the income is fixed in the stockholders of the appellant beyond its power to alter or interfere with * * *. In the absence of an income tax law to be taken into consideration, and there was no such tax in this state in 1881, we agree with appellant's contention that, when the person against whom the tax is sought to be laid has by valid contractual arrangement, made before the income tax law was enacted, put beyond his further command, beyond the right to stop payment, rentals to accrue, and has by solemn contract made the right to those rentals to exist in other persons, as vested property rights, then those rights cannot be changed or impaired without such third party's consent, and such rentals can be lawfully taxed as income only to those who beneficially own them, have control over them, and possess the right to do with them as they please. *Hoeper* v. *Tax Commission of Wisconsin*, 284 U. S. 206, 52 S. Ct. 120, 76 L. Ed. 248. If private property is to remain as an institution, rights under a contract must be beyond direct or indirect attack. The rights of individuals to the control over the income from the rental of appellant's property were fixed under a contract, the legality and full protection of which was not questioned in any way for upwards of fifty years, and which complies with all requirements of a legally sufficient agreement. We therefore conclude that a valid and enforceable agreement was entered into July 1, 1881, divesting the appellant of all control over the income as it accrues, and, so long as it is paid out of the revenues arranged for in the lease, that the only incomes arising out of the circumstances presented by this case are incomes flowing to the stockholders as individuals. The

appellant has no use of its property, it can have no use of the rentals during the life of the lease. The only way that rental can be taxed is as income of the individuals to whom the lessee is bound to pay, so long at least as no default occurs. The rent being by the agreement solely the property of the stockholders and belonging to no one else, it is difficult to see how the amount assessed can be raised by appellant."

The decision of the Wisconsin court was predicated upon conclusions that under the Wisconsin law the contractual right existing in favor of a third party beneficiary of the contract cannot be altered without his consent, and that this right cannot be changed or modified by either of the original parties to the contract without the agreement of the individuals who are the third party beneficiaries. The Wisconsin court had already concluded that the lessor could not collect the payments to be made to its stockholders because the right to those payments was vested in the stockholders; and that the interest of such stockholders is not derivative, but is that of a third-party beneficiary of a valid contract. (212 Wis. at p. 224, 248 N. W. at p. 165.)

It is undoubtedly true that such questions are in this case controlled by the law of Illinois. But in fact these principles of law of contract are of general application. For instance, the Restatement of the Law of Contracts recites (Section 142):

> "Unless the power to do so is reserved, the duty of the promisor to the donee beneficiary cannot be released by the promisee or affected by any agreement between the promisee and the promisor."

As was said by the Supreme Court of Illinois in the case of *Webster* v. *Fleming*, 178 Ill. 140, 145, 52 N. E. 975, 977, in quoting and adopting the principle as previously announced in *Bay* v. *Williams*, 112 Ill. 91, 96, 1 N. E. 340, 342:

> " 'It has ever been held by this court, that such a

promise inures to the benefit of the person for whose benefit it is made, and the right to sue is vested in him by force of the agreement itself.' "

And in *Western Union Tel. Co.* v. *Commissioner*, 68 Fed. (2d) 16, a case in which a lessee guaranteed payment of dividends to the lessor's stockholders, the court said (at p. 17):

> "* * * the shareholders of the lessor are donee beneficiaries of the lessee's promise; they may sue Western Union for the sums agreed to be paid to them; the lessee has no right to require rent to be paid to itself, and could not by arrangement with the lessee destroy the rights of the shareholders without their consent."

We think the point need not be labored. The conclusion of the Wisconsin Supreme Court in the *Northwestern Telegraph Company* case was accepted as correct, but not controlling, in the case of *Gold & Stock Telegraph Co.* v. *Commissioner*, 83 Fed. (2d) 465, the last of the line of decisions establishing income tax liability on the basis of income constructively received in lessor-lessee cases. In that case Judge Augustus N. Hand said of the *Northwestern Telegraph Company* case (83 Fed. (2d) at p. 467):

> "Its decision was placed upon the ground that the rights of the stockholders in the rentals were fixed by agreement of the parties and beyond the control of the lessor corporation. *While that is true*, the stockholders remained in receipt of income which came to them, though, under the agreement, because they were not merely promisees or assignees but stockholders still availing themselves of the corporation *to hold title on their behalf*." (Italics supplied.)

III.

A Corporation Which Neither Owns Nor Controls Any Property, Nor Has Any Right to or Control Over Any Income, Cannot Be in Receipt of Income, Constructively or Otherwise, Nor Subject to Income Tax Thereon.

The transaction evidenced by the indenture of January 1, 1864 stripped the stockholders of that corporation of every attribute then pertaining to their stock, except the right to vote for directors. The ownership of stock in a corporation ordinarily carries with it three principal perquisites—the right to a voice in the management; the right to participate in surplus profits when distributed; and the right to participate in the distribution of net assets in the event of dissolution.

The absolute conveyance of the respondent's properties on January 1, 1864, and the terms of the indenture effecting that conveyance, terminated all of these rights. Thenceforth the management of the property would be in the owner thereof. There could be no further earnings because the consideration for the conveyance was the promise of the grantee to pay to the third-party beneficiaries certain amounts designated by the term "dividends". Obviously a dissolution of respondent could result in no distribution of assets because the assets had all been transferred. If the payments promised by the indenture be deemed an asset received in exchange for the conveyance of the physical properties, the right to those payments was vested indefeasibly in the third-party beneficiaries.

The only function left for respondent corporation is the maintenance of a stock transfer book. This appears to be a superfluous function because under the indenture the payments in fact are made to a trustee for the stockholders, which is to hold the payments as a fund "for the

purpose of paying to said stockholders, *or to their legal representatives or assigns*" (R. 12) the "dividends" provided for in the indenture.

While it may be conceded that the indenture apparently contemplated the continued existence of respondent as a corporation (provisions made for nominal salaries of officers (R. 16)) there is no requirement to this effect. There is no necessity for the declaration of a dividend by this respondent, a circumstance that was present in *Terre Haute Electric Co.* v. *Commissioner,* 33 B. T. A. 975. There is no requirement that a holder of respondent's shares must be a *registered* holder, as was the case in *Blalock* v. *Georgia Ry. & Electric Co.,* 246 Fed. 387. Indeed, the very language of the indenture vests the right to the payments in the representatives and assigns of the shareholders.

Indeed, it would have been in no way inconsistent with the controlling indenture if The Chicago & Alton Company had in 1864 issued to the then holders of respondent's shares transferable certificates evidencing the right of those holders to receive the payments provided for under the indenture. Respondent could have been dissolved without any injury to the rights of the third party beneficiaries under the indenture. The situation that prevails today is exactly the same in substance as the situation that would have been created by such an arrangement. It is clear that in the supposed situation there could be no claim of constructive receipt of income by a corporation dissolved in 1864. By the same token there can be no proper claim of that character with respect to this respondent. There is nothing to indicate that this respondent's corporate existence is necessary for the preservation of the rights of the third party beneficiaries of the indenture of January 1, 1864. The indenture itself states that the obligation is to the holders of the shares and, through the Trustee, for those holders and their legal representatives and assigns.

It is equally apparent that this respondent could not demand payment to it of the payments provided for its stockholders. Similarly, payment to this respondent would not discharge The Alton Railroad Company of its obligation under the indenture.

In short, the transaction of January 1, 1864 divested this respondent's stockholders of every economic benefit that might accrue to them *as such stockholders*. In consideration thereof, the stockholders accepted the promise of the original grantee under that indenture (and its assigns) to make certain payments to a trustee for them. This is tantamount to an assignment, complete in 1864, of the right to these payments. It was made as part of a transaction in which respondent parted with its property and the management thereof, and made it certain that by no act of its own would it ever be able to engage in business or earn money.

The cases sustaining tax liability where the ordinary relationship of lessor and lessee exists cannot be controlling in such a situation. The theory of constructive receipt should be sparingly used in strong cases. It may be doubted that the constructive receipt cases relied on here may be so characterized; certainly they have stretched the theory to its last limit.

In each of the cases of this group cited by petitioner there was in fact a lease, and there was in fact a right in the lessor to enforce its provisions under threat for forfeiture. In their development of this tangential growth of the constructive receipt doctrine, the cases came to rely more and more upon the circumstance that the underlying title to the property producing the payments in question was in the corporation whose stockholders received the payments.

The evolution of the theory of constructive receipt, as applied in the lessor-lessee cases, began with the Corpora-

tion Excise Tax Act of 1909. (36 Stat. 11) In several cases arising under that law it was held that a lessor corporation was constructively in receipt of income under leases which were in fact leases. In every case title to the leased property was in the lessor. It is implicit in all of those decisions that a factor necessary to the conclusions was ownership by the lessor corporation of the property producing the income. In some of the opinions this is explicitly stated. For example, in *Houston Belt & Terminal Ry. Co.* v. *U. S.*, 250 F. 1, the court said (p. 3):

> "The title to the Terminal properties and the ownership of them was in the Terminal Company [the lessor]. * * *"

and emphasized that the payments made were the consideration for the use by the lessees of the property of the Terminal Company (p. 5).

In *West End Street Ry. Co.* v. *Malley*, 246 F. 625, the court said (at p. 626) that the "payments made were made by the lessee for its use of the corporation's [lessor's] property."

With variations required or suitable to each set of circumstances, the subsequent decisions have in general followed the lead originally indicated by these earlier cases under the 1909 Act. The most recent case which summarizes and seems largely to have settled the law is *Gold & Stock Telegraph Co.* v. *Commissioner*, 83 F. (2d) 465 (certiorari denied, 299 U. S. 564).

Brief consideration of the statements made in the course of Judge Augustus N. Hand's opinion in that case indicates conclusively that the conclusion was based on the fact of ownership of the property by the lessor.

In stating the case the court points out (p. 465):

> "In case of default in payment, the taxpayer had the option to terminate the agreement and resume possession of its property."

Again, at page 467, the court says:

"Here the retention of the status of stockholder beneficiaries with all the rights incident to that status of sharing, in proportion to their holdings of stock, in the rentals *which the property of their corporation yielded,* subjected them to the ordinary incidents of stockholders receiving payments from the earnings of their corporation and subjected the lessor corporation to taxes upon the income of the property of the group as a corporation.

* * * * *

"the stockholders remained in receipt of income which came to them, though, under the agreement, because they were not merely promisees or assignees but stockholders still availing themselves of the corporation to hold title on their behalf. * * * There is no sufficient ground for abating taxes upon such groups because of the agreement that the rentals shall be paid directly to the stockholders, when such rentals are *derived from the use of the corporate property.*"

In a contemporaneous case, *United States* v. *Northwestern Telegraph Co.,* 83 F. (2d) 468, the same court stated the same general proposition as follows (p. 469):

"We do not think that the stockholders can avail themselves of a corporate organization to avoid the double tax, which is ordinarily imposed *where income arises from the property of a corporation* and is paid to its stockholders, without subjecting themselves to such tax liabilities as may be inherent in the relation."

In short, the law as formulated requires that there be ownership of the property producing the income by the corporation whose stockholders receive it. In this respect the decisions have followed general principles of tax law.

An apt analogy is found in *Blair* v. *Commissioner,* 300 U. S. 5. That case presented the question of the liability of a beneficiary of a testamentary trust for a tax upon the income which he had assigned to his children prior to the

tax years involved, and which the trustees had paid to them accordingly. The state court had determined the assignment to be valid. (*Blair v. Linn*, 274 Ill. App. 23.) This court's analysis of the question there presented is interesting and apposite. It was said:

1. "The tax here is not upon earnings which are taxed to the one who earns them." (300 U. S., p. 11.)

So in the case at bar, so far as the earnings of the demised property are concerned, they are the earnings of the owner of that property—not the respondent, but The Alton Railroad Company.

2. "Nor is it a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation." (*id.* p. 11.)

So in the case at bar, no such question can arise except in relation to the income tax payments paid for respondent by The Alton Railroad Company. Such payments can be income to respondent only if it is liable for the taxes in the first instance.

3. "There is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion; or of the taxpayer's retention of control. *Corliss v. Bowers*, 281 U. S. 376; *Burnet v. Guggenheim*, 288 U. S. 280." (*id.* p. 12.)

So in the case at bar, obviously an arrangement set up in 1864 can in no sense be deemed an evasion or a prospective evasion of income tax laws that could be effectively promulgated only after adoption of the Sixteenth Amendment to the Federal Constitution in 1913. With equal obviousness it is clear that respondent has retained neither control over the property it demised in 1864 nor over the earnings therefrom.

4. "In the instant case, the tax is upon income as

to which; in the general application of the Revenue Acts, the tax liability attaches to ownership." (*id.* p. 12.)

So in the case at bar, the frail fiction of constructive receipt must find support, if it can, in ownership by the respondent of the property it demised by the indenture of January 1, 1864. It has already been shown that such support is utterly illusory. Lacking this essential factor, the fiction must fall.

We do not have in the case at bar a question of assignment of income without a segregation of the property producing the income. An apt analogy is found in *Nelson* v. *Ferguson*, 56 F. (2d) 121 (CCA3; certiorari denied 286 U. S. 565). There a patentee transferred his patent in consideration of a promise by the transferee to pay him one-third of the profits resulting from its exploitation. Thereafter he assigned the right to the one-third share in the profits to his wife. It was held that the income was taxable to his wife, the assignee, "not to the assignor who had ceased to own or control it." (*id.* p. 124.)

This court's comment on *Blair* v. *Commissioner, supra,* in *Helvering* v. *Horst*, 311 U. S. 112, 119, seems decisive:

> "Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away."

An interesting consideration is suggested by *Helvering* v. *Clifford*, 309 U. S. 331. There the question presented was whether or not the grantor of a five-year trust under which he named himself trustee (with almost unlimited discretionary powers), and his wife the income beneficiary, was nevertheless liable for taxes upon the income thereof. This court concluded that

> "The short duration of the trust, the fact that the

wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistably to the conclusion that respondent continued to be the owner for purposes of Section 22(a).'' (309 U. S., at p. 335.)

In reaching this conclusion the issue was defined to be

''whether the grantor, after the trust has been established, may still be treated, under this statutory scheme, as the owner of the corpus. See *Blair* v. *Commissioner,* 300 U. S. 5, 12.'' (309 U. S. at p. 334.)

This court said further that

''In absence of more precise standards or guides supplied by statute or appropriate regulations the answer to that question must depend on an analysis of the terms of the trust and all the questions attendant on its creation and operation. And where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary *lest what is in reality but one economic unit be multiplied into two or more,* by devices which, though valid, under state law, are not conclusive so far as Section 22(a) is concerned.'' (*id.* at pp. 334, 335.)

The case at bar presents the converse. In the *Clifford* case the taxpayer had sought to split his economic personality by creation of a temporary trust. In the case at bar, the indenture of 1864 effectively fused what had been theretofore two economic units into one. And insofar as the property theretofore owned by the plaintiff is concerned it has ever since been a part of what is obviously an economic unit, the Alton Railroad System.

It is no more open to the government to attempt to split one economic unit into two for the purpose of collecting taxes than it is open to a taxpayer to split his economic ''person'' for the purpose of avoiding taxes. To do so in this case would be ''to exalt artifice above reality.'' (*Gregory* v. *Helvering,* 293 U. S. 454, 470.)

The substance of the situation presented by the case at bar is that the property demised by the plaintiff in 1864

belongs to The Alton Railroad Company as successor to the original grantee thereof. The economic unit is the Alton Railroad system, which has long been recognized as such. The earnings of the demised property resulting from its operation by that company are taken into the accounts of the operating company. That is the economic unit actually involved. It makes the income from its operation, it receives the income, and it pays it out.

Common understanding and experience would certainly indicate that the earnings of the demised property, if any there be, should be deemed a part of the gross income of the corporation which owns the property—namely the Alton Railroad. True, for the years in question this company had no net taxable income (R. 35) but those were years of severe depression. The position urged by respondent and sustained by the court below means only that liability for tax will be placed where it should be; and that in periods of severe depression the Alton Railroad Company, a corporation whose business is affected with a public interest, would not be burdened by tax exactions based upon vestigial fictions. This result would in fact be "the taxation of income to those who earn or otherwise create the right to receive it and the benefit of it when paid." (*Helvering* v. *Horst*, 311 U. S. 112, 119.)

"That which is not in fact a taxpayers income cannot be made such by calling it income." (*Hoeper* v. *Tax Commission*, 284 U. S. 206, 215.) Insofar as the regulations relied upon here seek by fiat to classify the payments made to respondent's stockholders as income to respondent, they are obviously unconstitutional and void as they violate the due process clause of the Fifth Amendment.

IV.

In reply to petitioner's argument: The payments in question are not earnings of the respondent and do not constitute income attributable to it in the years in which the payments were made.

At the outset of its argument petitioner cites the constructive receipt cases, saying (Pet. br. p. 5) that those decisions "do not depend on the formal circumstances of the landlord and tenant relationship." They may not depend upon the *formal* circumstances, but they do depend upon the fact that the landlord and tenant relationship did exist, and the consequent fact that the lessor corporation was used by its stockholders to hold the title to the property producing the income which they received directly.

Petitioner would have it that the only difference resulting from the fact that the indenture of January 1, 1864 conveyed the fee to respondent's property, rather than leased that property, is that the payments made under the indenture are on account of purchase price rather than rental. (Pet. br. p. 5.) But the salient fact is that the indenture divested this respondent both of its property and of its right to receive income. So far as this respondent is concerned, the transaction was irrevocably completed when made, and by it the beneficiaries of the contract became indefeasibly vested with a right, enforceable by them directly, to receive the payments provided for by the indenture. Furthermore, a lessor under a long term lease has the sanction of forfeiture—a legal right of value for which the lessor corporation is still maintained by its stockholders.

It may be true, as petitioner urges at page 6, that continuing ownership of property is not decisive of taxability. But it has been decisive on the question of taxability in the constructive receipt cases upon which petitioner relies.

In the cases involving the gift or assignment of income, it is decisive. As this court said in *Helvering* v. *Horst*, 311 U. S. 112, 119, in discussing *Blair* v. *Commissioner*, 300 U. S. 5:

> "Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away."

Petitioner says, however (p. 6), that by reason of its dealings with its property, respondent "became entitled to profits which it directed to be paid to its stockholders". It should be noted that, so far as section 22 of the Revenue Act of 1928 (45 Stat. 791) and the similar provisions of subsequent acts are concerned, the only possible definition therein which is applicable in the case at bar is that relating to "dealings in property." So far as this respondent is concerned, its "dealing" with its property was completed in 1864.

But, the petitioner asserts, that by reason of its dealings the corporation became entitled to profits which it directed to be paid to its stockholders. We think this statement inaccurate. It may be fair to say that in negotiating the transaction this respondent could have been entitled to the payments. It may be fair to say that it exercised the power to transfer that right to its stockholders. But if so, that was done, and completely done, in 1864. And that is not a transaction that can give rise to liability for income tax seventy-five years later. This respondent received, in 1864, all that it was ever going to receive—its grantee's promise to its stockholders and their assigns.

Petitioner's footnote (6) (p. 6), asserts that "the argument that respondent corporation has no control over or interest in payments made by the Alton Company is untenable when it is remembered that the same is true of the lease cases in this regard." The significance of our ob-

servation is that where, in the lease cases, it was true that there was no control over the payments, the courts relied alone upon the fact that the corporation was used to retain the title to the income producing property. That ground does not exist in the case at bar. And in *Gold & Stock Telegraph Co.* v. *Commissioner,* 83 F. (2d) 465, the court was at pains to point out (at p. 467) that a difference would exist if there were an absolute assignment of income to the stockholders.

We do not contend, as petitioner asserts (p. 6), that the 1864 transaction left only the shareholders and the Chicago & Alton as parties interested in the Joliet & Chicago property, unless by "property" petitioner means not only the physical property transferred in 1864 but also the right to the payments undertaken by the Alton Company. The latter company owns the physical property; the payments under the indenture are the only economic right that the stockholders of this respondent have.

Petitioner next asserts that respondent stockholders received the payments as "dividends on stock". It is true they are so denominated. But they have no relation to earnings, and they are not dividends in fact. (cf. *Harwood* v. *Eaton,* 68 Fed. (2), 12, 14.) Petitioner also urges that the right to receive the payments is inseparable from the share rights. But the shares represent no other right of economic value. And the assertion of inseparability is negated by the provision that the trustee for the stockholders to whom the payments are to be made is bound to hold them for the purpose of making the payments to the stockholders, or to their legal representatives or assigns (R. 12).

We are at a loss to understand the pertinence of the petitioner's observation that respondent's stockholders stand in a position superior to the position of a stockholder of the Alton Company, assuming a reorganization and an exchange of stock. This is obvious. The illustration suggests, however, the very apposite analogy of debenture hold-

ers. A debenture is a promise to pay, enforceable by the holder thereof. Respondent's stockholders are in exactly the position they would be in if they were owners of Alton Company debentures.

Petitioner asserts (p. 7) that respondent's stockholders received income from the Alton Company by virtue of their corporate association. This assertion must fall before the obvious fact that respondent's stockholders received the payments by reason of the contract obligation of the Alton Railroad Company. While the promisees under that contract are identified as stockholders, their rights as promisees are not generated by their status as stockholders but by the contract in their favor. In the *Gold & Stock Telegraph Co. case* (83 F. (2d) 465), relied on by petitioner, the court reached the conclusion here asserted by the petitioner only because the stockholders availed themselves of their corporation to hold title on their behalf, (cf. 83 F. (2d) at p. 467.) As already suggested, if respondent had been dissolved and the Alton Company (or the trustee of the payments) issued transferable certificates evidencing the right to receive the payments, the third-party beneficiaries would be secured in their rights; respondent would not only be dead, as it is now, but buried.

The *Raybestos case* is not a helpful analogy (*Raybestos-Manhattan Co.* v. *U. S.* 296 U. S. 60). That case involved the question of liability for transfer tax. The rationale of the decision is well put in the final sentence (296 U. S. 60, 64):

> "Here, the power to command the disposition of the shares included the right to receive them, and the *exercise* of the power which transferred the right is subject to a tax." (Italics supplied.)

So it may be conceded that this respondent in 1864 exercised its power to transfer the income to be derived from the transaction to its stockholders, but it was a complete and irrevocable exercise in 1864.

We may agree with petitioner that "it is settled that realization of income by a taxpayer does not require actual passage of receipts into the taxpayer's hands" (Pet. br. p. 7). But we do not agree that there is any such realization where the taxpayer has divested himself completely of all right to the income and to the property producing it. And that is the case at bar.

Petitioner asserts that treasury regulations have long provided that payments of the kind here involved are taxable as income, despite a conveyance of the property, and that, therefore, these regulations should control. This contention is unsound. It is in the first place a fiction,[2] and the compounding of fictions thus suggested may well result in the complete loss of rights—the rights themselves will become a fiction. The statute itself may not require A to pay a tax because of B's income, and no administrative fiat, of however long standing, can have such effect. "Treasury Regulations can add nothing to income as defined by Congress." *M. E. Blatt Co. v. United States,* 305 U. S. 267, 279.

Furthermore, that part of the regulation purporting to apply to a situation like the present one has never been construed. Its meaning is at best ambiguous. The regulation purports to cover a situation "Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock * * *". It is then provided that "The fact that a corporation has conveyed or let its property * * * will not relieve it from liability to the tax".

Obviously, the regulation by the first provision purports to cover a situation involving a lease of corporate property on certain terms. Is the later provision an inept way of attempting to rule that the fact that a "lease" amounts

2. Cf. Brown, Regulations and Reenactment, 54 Harvard L. Rev. 377, 388; Paul, Use and Abuse of Tax Regulations in Statutory Construction, 49 Yale L. J. 660.

to a conveyance in fee (as it does in the case at bar) shall make no difference with respect to tax liability? Or does it purport to mean that there is no difference with respect to tax liability if the corporation has made a lease (of the type indicated) of some of its property, and has conveyed the rest? We think it must be said, as in the case of *Sanford's Estate* v. *Commissioner*, 308 U. S. 39, 49: "At most the regulation is ambiguous, and without persuasive effect in determining the true construction of the statute".

Conclusion.

In conclusion it is respectfully submitted that this respondent was divested in 1864 of its property and of its right to receive or control the payments to be made to the third-party beneficiaries under the indenture of January 1, 1864, that the decision of the court below is right, and should be affirmed.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

No. 151.—October Term, 1941.

The United States of America, Petitioner, *vs.* Joliet & Chicago Railroad Company.	On Writ of Certiorari to the United States Circuit Court of Apppeals for the Seventh Circuit.

[January 19, 1942.]

Mr. Justice Douglas delivered the opinion of the Court.

By an indenture denominated a "lease" respondent in 1864 granted, demised and leased to Chicago & Alton Railroad Co. all of its railroad property, real and personal. The "lease" was in perpetuity upon specified terms and conditions. The Chicago & Alton Railroad Co. covenanted and agreed, *inter alia,* to guarantee and pay quarterly to the holders of the fifteen thousand shares of capital stock of respondent an annual dividend of seven per cent on the par value of the shares; to deposit with a designated depository specified monthly sums to be placed to the credit of the stockholders and to be held as a fund for the purpose of paying the dividends; to pay the dividends without any deduction for any federal tax whatsoever; to pay all taxes which may be due to the United States "on account of said dividend so paid from time to time"; and to pledge to respondent thirty-seven parts out of two hundred and fifty-seven parts of the gross receipts of the line between the cities of Alton and Chicago for the purpose of securing the performance of its various covenants. The "lease" contained no defeasance clause.

The annual dividend is $7.00 per share and totals $105,000.00. This amount has been paid directly to respondent's stockholders every year since 1864—by Chicago & Alton Railroad Co. until acquisition of the property in 1931 by the Alton Railroad Co., and since then by the latter company. The dispute here is over federal income taxes for the years 1931, 1932, 1933 and 1934. Respondent, a corporation organized and existing under the laws of Illinois, filed its income tax return for each of those years report-

ing the $105,000.00 of dividends paid its shareholders as its income. The resulting tax was paid each year by the Alton Railroad Co. In addition the latter paid each year for respondent an additional tax on the amount of the income tax on $105,000.00 on the theory that the latter constituted additional taxable income to respondent. Respondent filed claims for refund for the additional tax paid in 1931 and for all the income taxes paid on its behalf for the other years in question on the theory that the income on which those taxes were paid was not realized by it. On rejection of those claims by the Commissioner respondent instituted suit in the District Court. That court rendered judgment for the petitioner. The Circuit Court of Appeals reversed, one judge dissenting. 118 F. 2d 174. We granted the petition for certiorari because of the conflict between that decision and the governing principles of *Gold & Stock Telegraph Co.* v. *Commissioner*, 83 F. 2d 465, *United States* v. *Northwestern Telegraph Co.*, 83 F. 2d 468, and *Pacific & Atlantic Telegraph Co.* v. *Commissioner*, 83 F. 2d 469, decided by the Circuit Court of Appeals for the Second Circuit.

Respondent urges, and the court below held, that this so-called lease in perpetuity without a defeasance clause divested respondent of all right, title and interest in the property and vested a full and indefeasible title in the grantee. See *Huck* v. *Chicago & Alton Railroad Co.*, 86 Ill. 352, 354-355; *Chicago, Burlington & Quincy R. R. Co.* v. *Boyd*, 118 Ill. 73. Respondent also argues that the indenture of 1864 vested all rights to payment of dividends in its stockholders and divested it of any right to, or control over, such payments. Respondent therefore contends that a corporation which does not own or control property and has no right to, or control over, any income from the property cannot be in receipt of income, constructively or otherwise.

Such considerations do not dispose of this controversy. In *Lucas* v. *Earl*, 281 U. S. 111, this Court held that a husband's salary was taxable to him though by contract with his wife half of it vested in her when paid. Mr. Justice Holmes said (pp. 114-115): "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction

can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."

Precisely that approach was taken in Art. 70 of Treasury Regulations 74, promulgated under the Revenue Act of 1928. It provides in part:

"Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the shareholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax."

That long standing regulation[1] is plainly applicable here. It covers various kinds of conveyances and leases including those where the grantor or lessor has parted with all rights of management and control over the property. If valid, it governs this case whatever may be the legal incidents of the 1864 indenture under Illinois law. Its validity seems clear. It is a permissible definition of one item of gross income[2] under § 22(a) of the Revenue Act of 1928, 45 Stat. 791, 797. Payments made directly to shareholders by the lessee or transferee of corporate property are properly recognized as income to the corporation by reason of the relationship of a corporation to its shareholders. The fact that there is an anticipatory arrangement whereby the taxpayer is not even a conduit of the payments is no more significant in this type of case than it was in *Lucas* v. *Earl*, *supra*.

The relationship between respondent and its shareholders is an abiding one. They obtain the dividend payments because of their status as shareholders. All questions of the rights of creditors aside, there can be no doubt that a corporation may normally dis-

[1] This regulation dates from Art. 80, Treasury Regulations 33 (1914 ed.). And see Art. 102, Treasury Regulations 33 (1918 ed.). Provisions similar to those quoted in the text are contained in Art. 70, Treasury Regulations 77, promulgated under the Revenue Act of 1932 and in Art. 22(a)-20 of Treasury Regulations 86, promulgated under the Revenue Act of 1934.

[2] Like definitions of gross income are contained in § 22(a) of the Revenue Act of 1932 (47 Stat. 169, 178) and in § 22(a) of the Revenue Act of 1934. 48 Stat. 680, 686.

tribute its assets among its stockholders. When it undertakes to do so, its act is nonetheless a corporate act though its shareholders receive new contractual rights enforceable by them alone against the transferee. That is to say their rights to receive the proceeds on the disposal of corporate assets are strictly derivative in origin. The fact that the consideration is made distributable to them directly over a long period of time rather than in one lump payment does not alter the character of those rights. In each case their claims to the proceeds flow from the corporation and are measured by the stake which they have in it. For the rental or purchase payments for the property conveyed by respondent could not lawfully be paid to another without its authority; and it could not lawfully dispose of them to others without the consent of its shareholders. Cf. *Raybestos-Manhattan, Inc.* v. *United States,* 296 U. S. 60. The fact that the corporation may remain in existence only to maintain a stock transfer book is immaterial. The umbilical cord between it and its shareholders has not been cut. The distribution made is in performance of the obligation owed by the corporation to them. For these reasons the regulation in question merely conforms to accepted legal theory. The conclusion that the dividend payments made to respondent's stockholders were income realized by it likewise marks no innovation in income tax law. That is indicated not only by *Lucas* v. *Earl, supra,* but also by those cases which hold that, "Income is not any the less taxable income of the taxpayer because by his command it is paid directly to another in performance of the taxpayer's obligation to that other." *Raybestos-Manhattan, Inc.* v. *United States, supra,* p. 64, and cases cited. The reach of the income tax law is not to be delimited by technical refinements or mere formalism. *Helvering* v. *Clifford,* 309 U. S. 331.

Since the dividend payments made to respondent's stockholders were income realized by it, the federal income tax on those sums which was paid by the Alton Railroad Co. was likewise income taxable to respondent. *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716; *United States* v. *Boston & Maine R. Co.*, 279 U. S. 732.

The judgment of the Circuit Court of Appeals is reversed and that of the District Court affirmed.

It is so ordered.

Mr. Justice ROBERTS did not participate in the consideration or decision of this case.